7/20

Office - Supreme Court, U. S.
FILED
MAY 17 1955
HAROLD B. WILLEY, Clerk

In the

Supreme Court of the United States

OCTOBER TERM, 1954

No. [redacted] 84

SAN ANTONIO TRANSIT COMPANY,
Petitioner,

v.

FRANK SCOFIELD, Formerly Collector of Internal Revenue,
Respondent.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

ROBERT ALLAN RITCHIE,
ROBERT F. RITCHIE,
(Counsel for Service),
1100 Republic Bank Building,
Dallas 1, Texas,

SYLVAN LANG,
LESLIE BYRD,
1500 Milam Building,
San Antonio 5, Texas,
Attorneys for Petitioner, San Antonio Transit Company.

WARLICK LAW PRINTING CO. - LAW BRIEF PRINTING - DALLAS - RI-6711

SUBJECT INDEX

Page

Reference to Reports 2

Jurisdiction 2

Questions Presented for Review 3

Statutes Involved 4

Statement of the Case 4

Argument:

I. The decision of the Court of Appeals in this case with reference to the "continuity of interest" test and the requirements that "substantially all the properties" to be acquired in tax-free reorganizations raises two important questions of federal law which have not been, but should be, settled by this Court 11

1. Application of the *Limestone* Case 11

2. The True Test for Continuity of Interest 17

II. The decision of the Court of Appeals in this case with reference to the "continuity of interest" test and the requirement that "substantially all the properties" be acquired in tax-free reorganizations is in conflict with decisions of the Supreme Court, other Courts of Appeals, and the Tax Court 23

III. The decision of the Court of Appeals in this case with reference to the requirement that a reorganization to be tax-free must be "solely for voting stock" indicates a conclusion in conflict with decisions of another Court of Appeals and the Tax Court 27

IV. The decision of the Court of Appeals holds in effect that Section 112(b)(5) does not operate to defer gain or loss in a creditors' reorganization, which holding is directly contrary to a

Page

decision of the Supreme Court and raises important questions of federal law which should be settled by this Court 30

V. The decision of the Court of Appeals to the extent that it holds that the "solely for stock" requirement is applicable to Section 112(b)(5) is contrary to prior decisions of the Supreme Court and raises questions of federal law which should be settled by this Court 35

VI. The decision of the Court of Appeals to the effect that a transaction under Section 112(b)(5) and Section 113(a)(8) results in the transferee corporation having the bondholders' basis rather than that of the old corporation is contrary to prior decisions of the Supreme Court and raises important questions of federal law which should be settled 38

Prayer 46

Page

Cases

Alabama Asphaltic Limestone Company v. Commissioner, 41 B.T.A. 324 (1940) 36

American Compress & Warehouse Company v. Bender, 70 F. 2d 655 (5 Cir., 1934) 32, 33

American Foundation Company v. United States, 120 F. 2d 807 (9 Cir., 1941) (41-2 U.S.T.C. par. 9613) 25

Becher v. Commissioner, ... F. 2d .... (2 Cir., 1955), 55-1 U.S.T.C. par. 9335, affirming 22 T. C. 932 (1954) 15, 21

Commissioner v. Carman, 189 F. 2d 363 (2 Cir., 1951) 25

Commissioner v. Cement Investors, Inc., 122 F. 2d 380 (10 Cir., 1941) 32

Commissioner v. Newton, 122 F. 2d 416 (10 Cir., 1941) 32

Connohio, Inc. v. Commissioner, 9 T. C. M. 1105, C. C. H. Dec. 18,002(M) (1950) 28

Cortland Specialty Co. v. Commissioner, 60 F. 2d 937 (2 Cir., 1932), cert. denied, 288 U. S. 599 (1933) 17-23

Four Twelve West Sixth Company v. Commissioner, 7 T. C. 26 (1946; acquiesced by the Commissioner, 1946-2 C. B. 2) 28

Gregory v. Helvering, 293 U. S. 465 (1935) 21, 22

Helvering v. Alabama Asphaltic Limestone Company, 315 U. S. 179 (1942) 9, 11-17, 19, 36, 37, 42-44

Helvering v. Cement Investors, Inc., 316 U. S. 527 (1942) 31-35, 38-43

Helvering v. Elkhorn Coal Company, 95 F. 2d 732 (4 Cir., 1938; cert. denied, 305 U. S. 605) 14

Helvering v. Gregory, 69 F. 2d 809 (2 Cir., 1934), affirmed 293 U. S. 465 (1935) 21, 22

Page

Helvering v. Minnesota Tea Company, 296 U. S. 378 (1935, affirming 76 F. 2d 797) 19

Helvering v. New President Corp., 122 F. 2d 92 (8 Cir., 1941) 41

Helvering v. Southwest Consolidated Corporation, 315 U. S. 194 (1942) 24, 27, 28, 36

Hoboken Land & Improvement Co. v. Commissioner, 138 F. 2d 104 (3 Cir., 1943, affirming 46 B. T. A. 495) 28

LeTulle v. Scofield, 308 U. S. 415 (1940) 19

Lewis v. Commissioner, 176 F. 2d 646 (1 Cir., 1949) 21

Miller v. Commissioner, 84 F. 2d 415 (6 Cir., 1936) .. 29

Montgomery Building Realty Company v. Commissioner, 7 T. C. 417 (1946; acquiesced by the Commissioner, 1946-2 C. B. 4) 29

Nelson Company v. Helvering, 296 U. S. 374 (1935) 19

Newton Trust Company v. Commissioner, 42 B. T. A. 473 (1940) 32

Peabody Hotel Company v. Commissioner, 7 T. C. 600 (1946; acquiesced by the Commissioner, 1946-2 C. B. 4) 15, 25-27

Pinellas Ice and Cold Storage Company v. Commissioner, 287 U. S. 462 (1933) 17-23

Portland Oil Co. v. Commissioner, 109 F. 2d 479 (1 Cir., 1940) 33

Reilly Oil Company v. Commissioner, 13 T. C. 919 (1949) and 189 F. 2d 382 (5 Cir., 1951) 15, 29

Roosevelt Hotel Company v. Commissioner, 13 T. C. 399 (1949; acquiesced by the Commissioner, 1950-1 C. B. 4) 28

Page

Scofield v. San Antonio Transit Company, 219 F. 2d 149 (5 Cir., 1955) .. 2, 15, 16, 20, 29, 38, 47-66

Southland Ice Company v. Commissioner, 5 T. C. 842 (1945; acquiesced by the Commissioner, 1946-1 C. B. 4) 28

Thurber v. Commissioner, 84 F. 2d 815 (1 Cir., 1936) 24

U. S. v. Santa Inez Co., 145 F. 2d 667 (9 Cir., 1944) 41

Westfir Lumber Company v. Commissioner, 7 T. C. 1014 (1946; acquiesced by the Commissioner, 1947-1 C. B. 4) 28

Statutes

Revenue Act of 1936,

Section 112(a) 4, 25, 67

Section 112(b) (4) 3, 4, 9, 13, 30, 33-37, 42, 67

Section 112(b) (5) 3, 4, 10, 30-45, 67

Section 112(e) 4, 37, 68

Section 112(g) (1) (B) .. 3, 4, 9, 13, 27, 30, 33-35, 42, 68

Section 113(a) (7) 3, 4, 69

Section 113(a) (8) 3, 4, 10, 30, 38, 70

Other Authorities

Spear, "Corporate Business Purpose in Reorganizations," 3 Tax Law Review 225 21

Treasury Regulations 86, Article 112(g)-1 21

Treasury Regulations 94, Article 112(a)-1 ..... 4, 20-22, 71

In the

Supreme Court of the United States

OCTOBER TERM, 1954

No. .....

SAN ANTONIO TRANSIT COMPANY,
Petitioner,

v.

FRANK SCOFIELD, Formerly Collector of Internal Revenue,
Respondent.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

To the Honorable, the Chief Justice and the Associate Justices of the Supreme Court of the United States:

Petitioner, San Antonio Transit Company, prays that a writ of certiorari issue to the United States Court of Appeals for the Fifth Circuit, which reversed the decision of the United States District Court for the Western District of Texas awarding petitioner a refund of federal income taxes in the net amount of $364,209.16 plus interest.

REFERENCE TO REPORTS

The opinion of the District Court in this case was not reported in the Federal Supplement, but it appears in 53-1 U. S. T. C., par. 66,053. The Findings of Fact and Conclusions of Law entered by the District Court are set forth on pages 122 to 133 of the Transcript of Record filed herewith. The Judgment of the District Court is set forth on pages 133-A to 133-D of said Transcript of Record.

The opinion of the Court of Appeals in this case, entitled *Scofield v. San Antonio Transit Company*, is reported in 219 F. 2d 149, and it also appears in 54-2 U. S. T. C., par. 9547, with the dissent in 55-1 U. S. T. C., par. 9240. Said opinion is appended to this petition as Appendix A.

JURISDICTION

(i) The original decision of the Court of Appeals in this case (No. 14784) was dated August 5, 1954.

(ii) The petition for rehearing in this case filed by San Antonio Transit Company was denied by the Court of Appeals on February 18, 1955. San Antonio Transit Company was granted a stay of the mandate to apply for and to obtain a writ of certiorari from the Supreme Court of the United States for a period of ninety days from February 18, 1955. No bond was required.

(iii) This Court has jurisdiction to review the judgment of the Court of Appeals for the Fifth Circuit in this case by writ of certiorari under the provisions of Title 28, U. S. C., Section 1254(1).

QUESTIONS PRESENTED FOR REVIEW

The basic question in this case is whether or not the taxpayer, on August 31, 1937, acquired title to the Smith-Young Tower Building pursuant to a tax-free creditors' reorganization within the provisions of Section 112(b)(4) and Section 112(g)(1)(B) of the Revenue Act of 1936, or pursuant to a tax-free exchange within the provisions of Section 112(b)(5) of said Act, so that the basis of the Smith-Young Tower Building to the taxpayer, for purposes of computing allowable depreciation and equity invested capital, should properly be held to be the adjusted cost basis to Smith Brothers Properties Company, the former owner of the Smith-Young Tower Building, pursuant to the provisions, respectively, of either Section 113(a)(7) or (8) of the Revenue Act of 1936.

To clarify the specific issues in this case the foregoing question should be subdivided into its component parts, as follows:

1. Was the requisite continuity of interest present in this reorganization?

2. Did the taxpayer acquire substantially all the properties of the transferor, Smith Brothers Properties Company?

3. Did the taxpayer acquire the property of the transferor solely for voting stock?

4. Does Section 112(b)(5) of the Revenue Act of 1936 apply to the creditors' reorganization involved in this case?

5. Does the "solely for stock" requirement apply to transactions under Section 112(b)(5) in the same manner as such provision applies under Section 112(g)(1)(B)?

6. Was Smith Brothers Properties Company the transferor so that its basis would be carried forward to the new corporation under the provisions of Section 113(a)(8)?

STATUTES INVOLVED

The pertinent provisions of the Revenue Acts and of the Treasury Department Regulations are set forth verbatim at the end of this Petition as Appendix B.

The applicable provisions of the Revenue Act of 1936, as amended, are as follows: Sections 112(a), 112(b)(4), 112(b)(5), 112(e), 112(g)(1), 113(a)(7), and 113(a)(8).

Also involved are the provisions of Treasury Department Regulations 94, Art. 112(a)-1.

STATEMENT OF THE CASE

A full statement of the facts in this case as found by the District Court is set forth at pages 122-131 of the Transcript of Record. The facts most pertinent to the issues are as follows:

Smith Brothers Properties Company was a Texas corporation which, during the real estate boom of the 1920's, acquired a tract of land in downtown San Antonio upon which it erected several buildings, the dominant structures being the Smith-Young Tower and the Plaza Hotel. The original cost of the Smith-Young Tower was $2,070,709.09

and the original cost of the Plaza Hotel and all buildings other than the Tower owned by the company was $2,769,-525.91. All of such buildings other than the Smith-Young Tower, hereinafter referred to as the "Plaza properties," were individually and jointly mortgaged under first, second and third mortgages held by institutional lenders, principally Massachusetts Mutual Life Insurance Company. The Smith-Young Tower, on the other hand, was not included in any of said mortgages but was the security for an issue of bonds which were widely sold to private investors over the country. (R. 20-26, 103.)

The depression of the 1930's brought on severe financial difficulties for Smith Brothers Properties Company and a protective committee was organized for the holders of Smith-Young Tower bonds. The protective committee caused the trustees for the bond issue to declare all of the bonds due and payable, and on January 2, 1932, the trustees filed suit in a State district court in San Antonio against the company for principal and interest on the bonds and foreclosure of the lien against the Smith-Young Tower. On the same date a receiver was appointed by the court who took possession of the Tower and operated it until the Tower was conveyed to taxpayer herein on August 31, 1937. (R. 27, 33, 34, 103, 104.)

In 1932 Smith Brothers Properties Company also defaulted on its obligations to Massachusetts Mutual Life Insurance Company and consequently possession and management of the Plaza properties were taken over by an agent for Massachusetts Mutual on March 1, 1933. No

progress was made towards the solution of the financial difficulties of the company until 1936 and 1937. (R. 28, 29, 103, 104.)

Century Investment Company, organized in 1936, offered to provide the necessary funds required to reorganize the company under Section 77B of the National Bankruptcy Act, which had been enacted in 1934 subsequent to the institution of the Smith-Young Tower foreclosure suit. However, it was determined that such a reorganization was not feasible. Century Investment Company then, on April 1, 1937, purchased several of the defaulted second mortgage notes owned by Massachusetts Mutual. On May 4, 1937, Century Investment Company foreclosed on these notes under the terms of the deed of trust securing said notes by a trustee's sale, and a corporation organized by Century Investment Company and known as the Plaza Company acquired title to the Plaza properties, leaving the Smith-Young Tower as the sole remaining asset of Smith Brothers Properties Company. No foreclosure suit or other judicial action was ever brought upon the indebtedness of Smith Brothers Properties Company secured by the Plaza properties, and the action of the Century Investment Company was entirely extra-judicial. The fair market value of the Plaza properties at this time was less than the amount of the lien indebtedness against such properties, and the same was true of the Smith-Young Tower properties. Smith Brothers Properties Company was insolvent in both the equity and bankruptcy senses at all times during the year 1937. (R. 29-31, 104.)

On October 29, 1936, the protective committee for the holders of Smith-Young Tower bonds entered into an agreement with Dallas Rupe & Son, Inc. (hereinafter referred to as "Rupe & Son"), the holder of a substantial amount of such bonds, to make possible the reorganization of the company. Rupe & Son agreed to furnish the funds necessary to pay nonassenting bondholders, for which it would receive the shares in the reorganized company to which such bondholders would have been entitled had they participated; and also to negotiate a loan for the new company. (R. 35, 104, 105.)

Subsequently a plan of reorganization was presented to the bondholders and to the court having jurisdiction of the receivership and foreclosure suit. On May 27, 1937, the court approved the plan of reorganization as fair and equitable, granted judgment to the trustees for the principal and interest on the Smith-Young Tower bonds, foreclosed the lien on such property, and ordered the receiver to offer same for sale on August 3, 1937, to satisfy the judgment. On said latter date the property was sold by the receiver and bid in by the nominee of the protective committee for $335,160.00. The sale was confirmed by the court on August 27, 1937. (R. 36-38, 105.)

Pursuant to the plan of reorganization the protective committee had organized a new corporation known as Smith Young Tower Corporation, whose name was later changed to San Antonio Transit Company, the taxpayer in this case. On August 31, 1937, the receiver conveyed the Smith-Young Tower and all remaining assets of Smith

Brothers Properties Company to taxpayer. A similar conveyance of said properties to taxpayer was made by Smith Brothers Properties Company. (R. 39, 40, 105.)

Also on August 31, 1937, all of the voting stock of taxpayer was issued to three voting trustees in consideration of the conveyance to the corporation of the Smith-Young Tower and equipment. Participating certificates were thereafter duly issued by the trustees to all depositing bondholders, such bondholders owning 91% of the total amount of such bonds, on the basis of one share for each $100.00 in principal amount of bonds held. The nonassenting bondholders were paid cash out of funds supplied by Rupe & Son for their pro rata share of the proceeds of the foreclosure sale, and the shares of the new corporation to which the nonassenting bondholders would have been entitled were issued to Rupe & Son. (R. 40-42, 105, 106.)

The receiver was discharged on October 8, 1937, and Smith Brothers Properties Company forfeited its charter on July 2, 1938. Taxpayer has continued in business to the present time. (R. 43, 44, 106.)

In its income tax returns for each year to and including its fiscal year ended May 31, 1943, taxpayer treated the foregoing transactions as constituting a tax-free reorganization in which the basis of the Smith-Young Tower and equipment in the hands of Smith Brothers Properties Company was carried over to the new corporation. For taxpayer's fiscal year 1943 the Commissioner of Internal Revenue determined for the first time that the transaction was not

tax-free and assessed a deficiency on such grounds. Taxpayer paid the deficiency under protest and filed suit for a refund thereof against the Collector of Internal Revenue in the United States District Court for the Western District of Texas. (Supp. R. 2.)

Said District Court had jurisdiction of this case by virtue of the fact that it was a civil action wherein the matter in controversy exceeded the sum of $3,000.00, exclusive of interest and costs, and arose under the internal revenue laws of the United States. 28 U. S. C., Section 1331.

After a trial of the case the District Court rendered judgment in favor of taxpayer in the net amount of $364,209.16, holding that there had been a tax-free reorganization within the meaning of Section 112(b)(4) and Section 112(g)(1)(B) of the Revenue Act of 1936. (R. 131, 132, 133-C.)

Upon appeal of this case by the Collector to the United States Court of Appeals for the Fifth Circuit, the Court of Appeals reversed the decision of the District Court and held that the date for applying the continuity of interest test for tax-free reorganizations and also for applying the statutory requirement that substantially all the properties of the transferor be acquired by the new corporation is the date the creditors first invoke the processes of the law to enforce their rights of full priority, which date was 1932 and 1933 in this case, citing *Helvering v. Alabama Asphaltic Limestone Company, 315 U. S. 179 (1942)*, in support

of this proposition. The Court of Appeals stated that "it is clear that their (the creditors') rights to claim a non-taxable reorganization under the statute date from the time when, because of insolvency, they displaced the stockholders."

On this basis the court then concluded that the reorganization of Smith Brothers Properties Company in 1937 was not tax-free because one of the groups of creditors had previously taken its mortgaged property by foreclosure and consequently did not participate in the reorganization, the court being of the opinion that the necessary continuity of interest was not shown and that substantially all of the properties of Smith Brothers Properties Company were not transferred to the new corporation.

The Court of Appeals also indicated that it seriously questioned the contention of taxpayer that it acquired the properties of Smith Brothers Properties Company "solely" for voting stock in view of the fact that the interests of nonassenting bondholders were acquired by Rupe & Son for cash. The point was not decided, however, because of the court's adverse holdings noted above.

With reference to taxpayer's alternative argument that there had also been a tax-free exchange as well as a tax-free reorganization in this case, the Court of Appeals stated that Section 112(b)(5) was of doubtful application "to an attempted creditors' reorganization effected in the manner presented to us here," and held that under Section 113(a)(8) the bondholders were the transferors of the

Smith-Young Tower when it was acquired by taxpayer and consequently taxpayer was not entitled to use the cost basis of Smith Brothers Properties Company for such property.

On petition for rehearing Circuit Judge Rives dissented, stating that he believed (a) that the requisite continuity of interest was clearly present in this case, (b) that taxpayer acquired not substantially, but literally, all of the properties of Smith Brothers Properties Company, (c) that the taxpayer acquired the property "solely for voting stock" even though the dissenting bondholders were paid in cash by Rupe & Son, and (d) that on taxpayer's alternative position the court erred in holding that the bondholders rather than the old corporation transferred the Tower building to the taxpayer.

ARGUMENT

I.

The decision of the Court of Appeals in this case with reference to the "continuity of interest" test and the requirement that "substantially all the properties" be acquired in tax-free reorganizations raises two important questions of federal law have not been, but should be, settled by this Court.

1. Application of the *Limestone* case.

In the case of *Helvering v. Alabama Asphaltic Limestone Company*, 315 U. S. 179 (1942), the Supreme Court held that the stockholders of an insolvent corporation are excluded when the creditors invoke the processes of the law

to enforce their rights, and that the creditors step into the shoes of the stockholders as owners of the equity in the corporation at that time, so as to furnish the necessary "continuity of interest" for a tax-free reorganization by the creditors. This is a practical, common sense decision ignoring legal technicalities and designed to facilitate compliance with the requirements for continuity of interest. It has been frequently applied and has become a landmark case in this field of tax law. But the case at bar is the first instance where the rule of the *Limestone* case has been applied to *defeat* a tax-free reorganization. The Court of Appeals has construed the rule to mean that a corporation which loses a portion of its property to some of its creditors during the course of its financial difficulties cannot be reorganized tax-free by the remaining creditors for lack of "continuity of interest" and because "substantially all of the properties" of the old corporation were allegedly not acquired by the new corporation. This deviation from the rule is not justified by the *Limestone* case and will give rise to a large amount of litigation since it is a common occurrence for financially embarrassed corporations either to lose or to dispose of portions of their properties, usually to satisfy the claims of creditors.

When the Supreme Court held in the *Limestone* case that the old creditors became the stockholders of the new corporation and that it conformed to realities to date their equity ownership from the time when they invoked the processes of the law, the Court was talking only about the propriety of treating the creditors of an insolvent corpora-

tion as the equity owners of the company, thereby establishing the requisite continuity of interest in spite of the fact that stockholders were eliminated from participation in the reorganization. The *time* at which the creditors acquired their equity ownership was of no particular importance except to show that the acquisition of the required proprietary interest did not result from the foreclosure sale. This is clearly evidenced by the following quotation from the Court's opinion:

> "* * * Plainly the old continuity of interest was broken. Technically that did not occur in this proceeding until the judicial sale took place. For practical purposes, however, it took place not later than the time when the creditors took steps to enforce their demands against their insolvent debtor. In this case, that was the date of the institution of bankruptcy proceedings. From that time on they had effective command over the disposition of the property. * * * When the equity owners are excluded and the old creditors become the stockholders of the new corporation, it conforms to realities to date their equity ownership from the time when they invoked the processes of the law to enforce their rights of full priority. At that time they stepped into the shoes of the old stockholders. The sale 'did nothing but recognize officially what had before been true in fact'." (315 U. S. 179 at 183-184.)

The Supreme Court did not state either expressly or by any reasonable implication that a reorganization is effected as of the date of insolvency or the commencement of legal proceedings, or that compliance with the reorganization statutes must be tested as of such date. The courts have never recognized that the exchange or acquisition required by Sections 112(b)(4) and 112(g)(1)(B) means

anything less than the transfer of full legal title on the date the reorganization is finally effected. Whether the reorganization is tax-free must be determined *as of the date of the reorganization.* Innumerable events might affect the properties of the old company. Voluntary and involuntary disposition might occur, including loss through casualty. The only character of disposition which would be material to the issue at hand would be that which was accomplished without a legitimate business purpose and with the sole view of effecting a technical compliance with the reorganization statutes, such as was the case in *Helvering v. Elkhorn Coal Company, 95 F. 2d 732 (4 Cir., 1938), cert. denied, 305 U. S. 605 (1938).* We have in this case no such disposition of properties to one group of equity owners for the purpose of satisfying the requirements of the law.

When one group of creditors cancels its equitable interest in an insolvent corporation by taking its security and going its separate way, why does not all of the equity shift to the remaining creditors the same as it originally shifted from the stockholders to the creditors? The Supreme Court in the *Limestone* case was merely saying that the reorganizing parties must have succeeded to the equitable interest in the old corporation and not that such interest becomes irretrievably vested in any particular group of persons, as the Court of Appeals seems to believe.

Numerous cases have been decided since the *Limestone* case involving reorganizations where properties of the transferor corporation were disposed of in order to pay

creditors in a tax-free reorganization. See, for example, *Reilly Oil Company v. Commissioner, 189 F. 2d 382 (5 Cir., 1951), affirming 13 T. C. 919 (1949)*, where it appeared that approximately one-half of the properties of the old corporation were sold by the trustee *(13 T. C. 919 at 922); Becher v. Commissioner, ... F. 2d ..... (2 Cir., 1955), 55-1 U. S. T. C. par. 9335, affirming 22 T. C. 932 (1954)*, where only 25.33% of the assets of the transferor were conveyed to the new corporation; and *Peabody Hotel Company v. Commissioner, 7 T. C. 600 (1946; acquiesced by the Commissioner, 1946-2 C. B. 4)*, where two simultaneous reorganizations, each involving substantial properties of an insolvent corporation, were effected. The decision of the Court of Appeals in the case at bar would necessitate a contrary holding in such cases and, if this decision is allowed to stand, future litigants seeking to defeat a tax-free reorganization will endeavor to prove any sort of disposition of property or elimination of creditors under the rule of this case. Since the Court of Appeals did not specify with any particularity the limits of its holding in this connection, a considerable number of decisions would be required to establish a reasonably accurate dividing line between a taxable and a nontaxable reorganization in such a situation, thus giving rise to additional uncertainty and confusion in this field of income tax law.

None of such litigation is justified by the *Limestone* case. The dissent by Judge Rives in the case at bar puts the matter succinctly in this language:

> "In our original opinion, referring to the Limestone Case, 315 U. S. 179, we held that the critical time for

determining whether the taxpayer acquired 'substantially all the properties' of the transferor was 1932 or 1933, the date of insolvency, rather than 1937, when the title to the property passed to the new corporation. It now seems clear to me that, under the teachings of the Limestone case, *supra*, the earlier date has reference only to the time when the bondholders stepped into the shoes of the stockholders, and that the later date is the one when the reorganization was perfected, and which we should consider in determining whether the taxpayer acquired 'substantially all the properties' of the old corporation. In the Limestone case, *supra*, the tax-free reorganization was approved even though the bondholders had theretofore stepped into the shoes of the stockholders. In the present case, as of 1937, there can be no question but that the taxpayer acquired not substantially, but literally, all of the properties of Smith Brothers Properties Company.

"In 1932 or 1933, the separate sets of bondholders stepped into the shoes of the stockholders. The bondholders were divided into two separate groups, each interested in the properties securing their respective bonds. Neither group was interested in the other group or in the properties securing its bonds, because the corporation was insolvent, the security represented the value of the bonds of either group and was insufficient to pay those bonds in full. There was no remaining equity in which the other group could be interested. In 1932 or 1933, the properties of Smith Brothers Properties Company were thus, in effect, split into two portions, and as to each portion separately the bondholders stepped into the shoes of the stockhlders. Further, the other group of bondholders and the security for its bonds had been completely severed from the old corporation before the present rerganization was effected. While, therefore, it may not be necessary for a decision of the case, there seems to me to be no objection to divisive or multiple reorganization. * * *." (219 F. 2d 149 at 158.)

The basic principle of the *Limestone* case is of great importance to income tax jurisprudence and the dating-back process employed by the Court of Appeals in the case at bar upon the authority of the *Limestone* case creates an important and hitherto unheard of principle which will cause extensive litigation in the future unless reviewed by the Supreme Court.

2. The True Test for Continuity of Interest.

The Court of Appeals has here departed radically from the true test of continuity of interest in tax-free reorganizations. The essence of the holding in this case is that continuity of interest is lacking because one property of the enterprise was separately foreclosed and removed from the old corporation by the creditors holding a lien on such property.

Neither the amount of the property involved nor the activities of other creditors have any bearing on the continuity of interest test. To demonstrate this fact an examination of the origin of the continuity of interest test is necessary. The Court well knows that the rule requiring continuity of interest did not originate in the Internal Revenue Code; rather, it was judicially developed to plug a so-called loophole left by Congress in the Code. The landmark cases giving birth to the continuity of interest test were *Cortland Specialty Company v. Commissioner, 60 F. 2d 937 (2 Cir., 1932), cert. denied, 288 U. S. 599 (1933);* and *Pinellas Ice & Cold Storage Company v. Commissioner, 287 U. S. 462 (1933).*

The essential facts in the *Cortland* and *Pinellas* cases were almost identical: no insolvency was involved and in each case the old corporation was sold for cash and short term notes. The basic premise asserted by the Court in each instance was that a sale for cash cannot be tax-free, and that a sale for anything so nearly resembling cash as short term notes must be treated the same as a sale for cash. Ancillary to its arguments in support of this rule the Court in the *Cortland* case stated that "there must be some continuity of interest on the part of the transferor corporation or its stockholders in order to secure exemption." *60 F. 2d 937 at 940.* The only literal reference to "continuity of interest" made by the Supreme Court in the *Pinellas* case was as follows: "Certainly, we think that to be within the exemption the seller must acquire an interest in the affairs of the purchasing company more definite than that incident to ownership of its short term purchase money notes." *287 U. S. 462 at 470.* But the fundamental holding in both of these decisions was that a sale for cash or the equivalent of cash cannot be tax-free, as demonstrated by the following quotation from the *Pinellas* case:

> "* * * It would require clear language to lead us to conclude that Congress intended to grant exemption to one who sells property and for the purchase price accepts well secured, short term notes (all payable within four months), when another who makes a like sale and receives cash certainly would be taxed. We can discover no good basis in reason for the contrary view and its acceptance would make evasion of taxation very easy. *In substance the petitioner sold for the equivalent of cash;* the gain must be recognized. (287 U. S. 462 at 469. Italics added.)

Subsequent cases have applied this "continuity of interest" rule to varying fact situations. For example, see *Nelson Company v. Helvering, 296 U. S. 374 (1935)* (reorganization tax-free where old stockholders received cash and non-voting preferred stock of the transferee corporation); *Helvering v. Minnesota Tea Company, 296 U. S. 378 (1935)* (reorganization tax-free where old stockholders received cash and 7.5% of the common stock of the transferee corporation); *LeTulle v. Scofield, 308 U. S. 415 (1940)* (reorganization not tax-free where old stockholders received only cash and long term bonds); and *Helvering v. Alabama Asphaltic Limestone Company, 315 U. S. 179 (1942)* (the proprietary interest vests in the creditors of an insolvent corporation and there is continuity of interest where the transferee corporation issues its stock to such creditors).

Despite the slogan by which the rule is identified and despite all the learned exposition on the subject, judicial and otherwise, it is clear that the fundamental and basic purpose of the continuity of interest rule is to prevent a sale for the equivalent of cash from being tax-free, although it complies with the literal requirements of the statute. Can there be any justification for this requirement which has been judicially engrafted upon the statutory provisions if such is not the case? The Court of Appeals in the *Cortland* case and the Supreme Court in the *Pinellas* case indicated that it was beyond the obvious purpose of the Congress to include a sale for substantially the equivalent of cash within the tax-free reorganization provisions.

Subsequent cases have been nothing more nor less than refinements of this principle tailored to suit the facts in each individual case.

There is no requirement of "continuity" purely for the sake of continuity only. It is unfortunate that the popular title of the rule does not more accurately describe is true intent, as demonstrated by the case at bar. The Court of Appeals has here pursued an objective labeled "continuity" which has no reasonable connection with the fundamental purpose of the rule. The ends of justice would be much better served if the popular slogan were "the equivalent of a sale for cash" instead of "continuity of interest," since the former expresses the essence of the rule, while the latter merely describes an incidental by-product.

The opinion of the dissenting judge in this case summarizes the matters as follows:

> "In the present case, the retained interest was common stock, the purest form of proprietary or equity interest in a corporation, and that stock represented the full value of the property transferred. It seems clear to me that the court made rule of continuity of interest has been met." (219 F. 2d 149 at 158.)

What, then, was the basis of the decision in the case at bar? The Court of Appeals stated in its opinion that "Compositely, the cases mean simply that facts must be presented from which it can be reasonably concluded that the new corporation is in substance the old corporate enterprise in a new form," citing Article 112(a)-1 of Treasury Regulations 94, promulgated under the Revenue Act of 1936. *(219 F. 2d 149 at 153-154.)*

The Court of Appeals construed the foregoing regulations to mean that the taxpayer was thereby required to take over the entire business of Smith Brothers Properties Company as it existed in 1932 or 1933. This position is untenable because continuity of the business enterprise properly requires only that the new corporation carry on a business. *Becher v. Commissioner, ... F. 2d .... (2 Cir., 1955), 55-1 U. S. T. C. par. 9335, affirming 22 T. C. 932 (1954);* and *Lewis v. Commissioner, 176 F. 2d 646 (1 Cir., 1949).*

The requirement of continuity of the business enterprise containedd in Treasury Regulations 94 first appeared in the regulations promulgated under the Revenue Act of 1934, Regulations 86, Articles 112(a)-1 and 112(g)-1, and were intended as a restatement of the then case law. Spear, *"Corporate Business Purpose in Reorganizations," 3 Tax Law Review 225, 232.* The case law on the subject at such time essentially consisted of the following decisions: *Pinellas Ice & Cold Storage Company v. Commissioner, 287 U. S. 462 (1933),* discussed above; *Helvering v. Gregory, 69 F. 2d 809 (2 Cir., 1934),* later affirmed in *Gregory v. Helvering, 293 U. S. 465 (1935),* holding that there was no tax-free reorganization where the transferee corporation conducted no business and was promptly dissolved after serving merely as a conduit for the distribution of certain assets of the transferor to its sole stockholder; and *Cortland Specialty Company v. Commissioner, 60 F. 2d 937 (2 Cir., 1932), cert. denied, 288 U. S. 599 (1933),* also discussed above.

The *Cortland* case contains the following language, *60 F. 2d 937* at *940:*

> "* * * In defining 'reorganization,' section 203 of the Revenue Act gives the widest room for all kinds of changes in corporate structure, but does not abandon the primary requisite that there must be some continuity of interest on the part of the transferor corporation or its stockholders in order to secure exemption. Reorganization presupposes continuance of business under modified corporate forms."

It is clear, therefore, that the language contained in Treasury Regulations 94 cited by the Court of Appeals in footnote 7 of its opinion *(219 F. 2d 149* at *154)* is nothing more nor less than (1) the requirement of the *Gregory* case that the transferee, the new enterprise, must continue in business without being liquidated, and (2) the continuity of interest requirement set forth in the *Cortland* and *Pinellas* cases, which is that the retained interest in a tax-free reorganization must include a proprietary or equity interest in the transferee, as opposed to solely a creditor's interest, *i.e.*, there cannot be a sale for cash or its equivalent. The Court of Appeals in the case at bar has adopted a strange amalgamation of the principles of the *Cortland* and *Pinellas* cases, on the one hand, and the *Gregory* case on the other. The court did not cite the *Gregory* case but extracted its essence from the aforesaid Treasury Regulations. The flavor was altered in the process, and what was originally a simple requirement of the *Gregory* case that the new corporation must continue the business transferred to it instead of liquidating same (which really means that

the transaction must not be purely a sham), has been converted into a prohibition against the tax-free reorganization of a business which has been reduced by foreclosure so that only one of its two original substantial groups of properties remains. The Court of Appeals here has wholly departed from the basic concept, and even the refinements, of the continuity of interest rule and has created a new limitation upon tax-free reorganizations, disguised in the cloak of "continuity of interest," which will give rise to much uncertainty and litigation. It is of paramount importance to taxpayers and the government that the substance of the continuity of interest rule be plain and unequivocal. The confused application of these principles by the Court of Appeals creates a dangerous precedent and requires the review of the Supreme Court to reestablish the true continuity of interest and business enterprise rules set forth above.

II.

The decision of the Court of Appeals in this case with reference to the "continuity of interest" test and the requirement that "substantially all the properties" be acquired in tax-free reorganizations is in conflict with decisions of the Supreme Court, other Courts of Appeals, and the Tax Court.

The Court of Appeals held in this case, involving a creditors' insolvency reorganization, that the requirement of "continuity of interest" and the requirement that "substantially all the properties" be acquired by the new cor-

poration must be applied to the creditors and to the properties of the old corporation as they existed in 1932 or 1933 when the corporation became insolvent, rather than applying such rules as of the date when the reorganization was actually effected, August 31, 1937. Such holding is contrary to the ruling of this Court in *Helvering v. Southwest Consolidated Corporation, 315 U. S. 194 (1942).*

The contention was made in the *Southwest Consolidated* case that an event transpiring some time after the reorganization exchange should be taken into consideration so as to justify a tax-free reorganization. The Supreme Court stated the rule to be that "The critical time is the date of the exchange," *315 U. S. 194* at *201*, and refused to apply the test at any other date.

In addition, various Courts of Appeal have also held that the time for testing a reorganization for compliance with the tax-free exchange requirements is the date of the exchange itself. In *Thurber v. Commissioner, 84 F. 2d 815 (1 Cir., 1936)*, the Court of Appeals made the following observation at *page 818:*

> "* * * We do not doubt that the assets of a corporation which is to be merged may, by agreement of the persons concerned, be reduced by distribution to its stockholders before the merger takes place, so that the stock at the time when the merger is consummated will have the value which the merger contemplates. There is an explicit finding that this was the purpose of the special dividend just referred to. The statute means that all free assets of the corporation *at the time of the actual merger* shall be transferred to the new corporation; and this was done in the present case." (Italics added.)

In construing the tax-free reorganization provisions the Court of Appeals for the Second Circuit in *Commissioner v. Carman, 189 F. 2d 363 (2 Cir., 1951)*, stated the rule to be as follows, at *page 366:*

> "* * * Section 112(a) clearly refers to *the date of the exchange* as the date which determines whether gain or loss shall be recognized. To take a hypothetical date which is not the actual date of the exchange disregards the 'firmly established principle of tax law that the ordinary meaning of terms is persuasive of their statutory meaning'." (Italics added.)

In *American Foundation Company v. United States, 120 F. 2d 807 (9 Cir., 1941)* (reported in full in *41-2 U. S. T. C. par 9613)*, the Court stated the rule to be as follows:

> "It is now recognized that the *value at the time of the transfer* is the proper basis for determining the percentage of property transferred and retained and on that basis the plaintiff-appellant transferred 92.6% of its property and retained 7.4%. Under the decided cases such percentage represents substantially all of the property." (Italics added.)

The decision of the Court of Appeals in the case at bar is also in direct conflict with an interesting decision of the Tax Court, *Peabody Hotel Company v. Commissioner, 7 T. C. 600 (1946; acquiesced by the Commissioner, 1946-2 C. B. 4)*. The *Peabody* case involved a reorganization under Section 77B of the National Bankruptcy Act. The old corporation owned two properties, the Peabody Hotel and the Gayoso Hotel. Both properties were separately mortgaged and each property was worth less than the mortgage lien

against it, exactly the same situation as in the case at bar. Pursuant to the reorganization plan the Gayoso Hotel was transferred to a new corporation and the Gayoso bondholders received all the stock of such corporation. Simultaneously the Peabody Hotel was transferred to another new corporation whose stock was issued to the Peabody bondholders, creditors, and the old stockholders who paid $7.00 cash per share to participate in the reorganization. The Tax Court held that the Peabody Hotel reorganization was tax-free under the same statutory provisions as those involved in the case at bar. The Tax Court found that the requisite continuity of interest was present and that substantially all the properties of the old corporation had been acquired by this new corporation, despite the fact that a substantial portion of the properties of the old corporation was not included in the Peabody Hotel reorganization, since the Gayoso creditors did not have any equity in the Peabody Hotel.

In the case at bar the Court of Appeals disposed of the *Peabody* case on the ground that in such case there was one unified insolvency proceeding to which all creditors were parties, whereas in the instant case there were two independent groups of creditors each of which proceeded separately. This is purely a distinction without a difference in the light of underlying principles in the *Peabody* case. The rule of such case was that the two groups of creditors were mutually exclusive and independent of each other for purposes of the continuity of interest test, and therefore

there can be no logical basis for requiring them to take action in the same court proceeding.

The rationale of the *Peabody* case is directly applicable to the case at bar if the existence of the Plaza properties and the Plaza creditors must be given any consideration. However, the facts plainly show that such properties and such creditors had been eliminated prior to the effective date of the exchange involved in this case, August 31, 1937, and such date is the proper time to apply the test for a tax-free reorganization under the *Southwest Consolidated* case and other cases discussed above.

Consequently, it is clear that the decision of the Court of Appeals here conflicts with the decisions of the Supreme Court, the Courts of Appeals for the First, Second and Ninth Circuits, and the Tax Court of the United States.

III.

The decision of the Court of Appeals in this case with reference to the requirement that a reorganization to be tax-free must be "solely for voting stock" indicates a conclusion in conflict with decisions of another Court of Appeals and the Tax Court.

With reference to the requirement of Section 112(g)(1)(B) of the Revenue Act of 1936 that a reorganization to be tax-free must be "solely for voting stock," the Court of Appeals stated that the fact in this case that the non-assenting bondholders were paid in cash from funds sup-

plied by Rupe & Son raised a "serious and very close question," citing *Helvering v. Southwest Consolidated Corporation, 315 U. S. 194 (1942)*, holding that nonassenting bondholders could not be paid in cash by the transferee corporation. However, the point was not reached in the case at bar because of the decision of the Court of Appeals on the preceding questions.

A holding adverse to the taxpayer on this point would be in direct conflict with the decision in another Court of Appeals case and in numerous Tax Court cases, and the doubt expressed by the Court in this case will lead to confusion upon this important phase of reorganization law.

The payment of cash to nonassenting security holders by a participating security holder, exactly the same arrangement as in the case at bar, was held not to defeat a tax-free reorganization in *Hoboken Land & Improvement Company v. Commissioner, 138 F. 2d 104 (3 Cir., 1943), affirming 46 B. T. A. 495 (1942)*. Furthermore, the Tax Court has arrived at the same conclusion in a series of cases: *Southland Ice Company v. Commissioner, 5. T. C. 842, 848 (1945; acquiesced by the Commissioner, 1946-1 C. B. 4); Westfir Lumber Company v. Commissioner, 7 T. C. 1014, 1017 (1946; acquiesed by the Commissioner, 1947-1 C. B. 4); Roosevelt Hotel Company v. Commissioner, 13 T. C. 399, 408 (1949; acquiesced by the Commissioner, 1950-1 C. B. 4); and Connohio, Inc. v. Commissioner, 9 T. C. M. 1105, 1106 (1950)*. Also see *Four Twelve West Sixth Com-*

pany v. Commissioner, 7 T. C. 26 (1946; acquiesced by the Commissioner, 1946-2 C. B. 2); and *Montgomery Building Realty Company v. Commissioner, 7 T. C. 417, 426 (1946; acquiesced by the Commissioner, 1946-2 C. B. 4).*

The issue was met squarely by the dissent in the case at bar, as follows:

> "The taxpayer corporation itself parted with nothing but voting stock in acquiring the Tower Building. The fact that part of that voting stock went to reimburse or compensate Rupe & Son, who furnished the funds to pay off the nonassenting bondholders, representing about 10% of the total bonds, does not defeat this requirement. The taxpayer got the property 'solely for voting stock,' even though Rupe & Son stepped into the shoes of the dissenting bondholders." (219 F. 2d 149 at 158-159.)

If the decision of the Court of Appeals in the case at bar is permitted to stand, this question which had previously been laid to rest by the foregoing cases will undoubtedly be reopened and the result will be extended litigation on the subject. The question is one of great importance, since it is almost universal experience for there to be nonassenting parties in a plan for reorganization. *Reilly Oil Company v. Commissioner, 189 F. 2d 382, 384 (5 Cir., 1951),* and *Miller v. Commissioner, 84 F. 2d 415, 419 (6 Cir., 1936).* Therefore, this issue in the case constitutes an important question of federal law which should be settled by this Court.

IV.

The decision of the Court of Appeals holds in effect that Section 112(b)(5) does not operate to defer gain or loss in a creditors' reorganization, which holding is directly contrary to a decision of the Supreme Court and raises important questions of federal law which should be settled by this court.

Petitioner contended below that, in addition to meeting the requirements of Section 112(b)(4) and Section 112(g)(1)(B), the transaction in question was tax-free under Section 112(b)(5) of the Revenue Act of 1936. The Collector urged: (1) that Section 112(b)(5) required that the exchange be "solely for stock" and in such regard said section was identical with the requirement of Section 112(g)(1)(B); (2) that if Section 112(b)(5) be held applicable, that the bondholders rather than the old corporation must be treated as the transferors, and that under Section 113(a)(8) the bondholders' basis would be the fair market value of the property at the time of the receiver's sale. No contention was made by the Collector that the "substantially all" requirement of Section 112(g)(1)(B) prevailed under Section 112(b)(5). The Court of Appeals on the issue of the application of Section 112(b)(5) held that "there is considerable doubt that Section 112(b)(5) applies to an attempted creditors' reorganization effected in the manner presented to us here." From this expression by the Court of Appeals, it must be assumed that the Court either: (a) questioned the applicability of Section 112(b)(5) to the transaction involved, or (b) held that

the "solely for stock" requirement applied and had not been complied with. Of course, the Court may have been actuated by doubt with respect to both such issues. In all events, the Court's failure to find that Section 112(b)(5) was applicable and that its requirements were fully met, is directly opposed to the Supreme Court's decision in *Helvering v. Cement Investors, Inc., 316 U. S. 527 (1942).*

In the *Cement Investors* case, the taxpayers owned first mortgage bonds of Colorado Industrial Co. which were guaranteed by the parent company, Colorado Fuel and Iron Co. After default on these bonds and certain bonds issued by the parent company, each company filed a petition under Section 77B of the Bankruptcy Act. A plan of reorganization was formulated under which the assets of both companies would be transferred to a new company which would assume the obligations of the bonds of the parent company and issue certain income bonds and common stock in exchange for the bonds of the subsidiary company. The stockholders of the debtor companies were to receive warrants for the purchase of stock in the new company in exchange for their stock in the old company. The plan was consummated and the properties of both companies were conveyed to the new company by conveyances joined in by the old companies, the trustee in bankruptcy, and the trustee under the indenture securing the bonds of the old subsidiary company. The taxpayers exchanged their subsidiary company bonds for common stock and income bonds of the new company. The fair market value of the new securities exceeded the basis of the old, and the Commissioner, ac-

cordingly, determined taxable gain on the difference on the grounds that the exchange was a taxable transaction. The Board of Tax Appeals held for the taxpayers in *Newton Trust v. Commissioner, 42 B. T. A. 473 (1940)*, holding that the transaction was tax free under 112(b)(5). The Circuit Court of Appeals for the Tenth Circuit affirmed in *Commissioner v. Cement Investors, Inc., 122 F. 2d 380 (10 Cir., 1941)*, and *Commissioner v. Newton, 122 F. 2d 416 (10 Cir., 1941)*, on the grounds that the exchange met the requirements of Section 112(b)(5). The Supreme Court granted writ of certiorari "because the application of Section 112(b)(5) to receivership or bankruptcy reorganizations raised important problems in the administration of the income tax, and affirmed the case. *Helvering v. Cement Investors, Inc., 316 U. S. 527, 530 (1942).*

In our judgment, there cannot be the slightest trace of doubt about the Supreme Court's clear-cut holding that Section 112(b)(5) is applicable to creditors' insolvency reorganizations. On that score the Court stated:

> "* * * While the 'reorganization' revisions are restricted to inter-corporate transactions, Section 112(b)(5) is not so confined, since the phrase 'one or more persons' includes 'individuals, trusts or estates, partnerships and corporations.' Treasury Reg. 94, Art. 112(b)(5)-1. But there is no indication that the 'reorganization' provisions were designed as the exclusive method of deferring recognition of gain or loss in all cases of corporate readjustments or reorganizations. The history of Section 112(b)(5) makes clear that it too was designed to function in that field (American

> Compress & Warehouse Co. v. Bender (C. C. A., 5th), 70 F. 2d 655, 657, 658) and to permit deferment of gains or losses where 'there has been a mere change in the form of ownership' or where the taxpayer has not 'closed out a losing venture.' Portland Oil Co. v. Commissioner of Internal Revenue (C. C. A., 1st), 109 F. 2d 479, 488. Section 112(b) (5) derives from Section 202(c) (3) of the (November 23), 1921 Act. 42 Stat. at L. 227, 229, 230, chap. 136. Its legislative history shows that it was designed to permit 'readjustments' without present recognition of gain or loss by allowing property to be transferred to a controlled corporation by an individual, a partnership, a corporation, or others." (316 U. S. 527, 533.)

It is equally clear under the holding in the *Cement Investors* case that Section 112(b) (4), together with related Section 112(g) (1), and Section 112(b) (5) can and do apply independently of each other so that a particular transaction may meet the requirements of one but not the other, and that the failure of a transaction to meet the requirements of one has no bearing on the possible application of the other, although some transactions may meet the requirements of both. The following language admits of no other conclusion:

> "* * * The close relationship between Section 112(b) (5) and the 'reorganization' provisions is further evidenced by the fact that they overlap to a degree. Thus a transaction which meets the requirements of clause B or clause C of Section 112(g) (1) may also qualify under Section 112(b) (5). In short, the 'reorganization' provisions do not furnish the exclusive methods for securing a deferment of gains or losses arising out of transactions popularly known as corporate readjust-

ments or reorganizations. The instant transaction comes fairly within the family of business readjustments for which Section 112(b) (5) was designed. Hence the fact that it cannot meet the statutory standards of a 'reorganization' does not necessarily mean that it cannot qualify as an 'exchange,' any more than the failure to satisfy one clause of the 'reorganization' provisions means that none can be satisfied." (316 U. S. 527, 534.)

Furthermore, the Supreme Court in considering Section 112(b) (5) in the *Cement Investors* case clearly applied the principle of the *Limestone* case to the effect that creditors of an insolvent corporation step into the shoes of the stockholders and thereby become owners of the equitable interest in the corporation. Hence, it is clear that the Supreme Court applies the theory that creditors displace stockholders in an insolvent corporation both when considering the application of Section 112(b) (4) or when dealing with 112(b) (5). As has already been pointed out, the decision of the Court of Appeals recognizes that the principle of the *Limestone* case applies to the facts in the case at bar with reference to construing the application of Section 112(b) (4) and Section 112(g) (1) (B), yet when it comes to a consideration of Section 112(b) (5), the Court has questioned the application of Section 112(b) (5) in a manner which seriously confuses the law as pronounced in the *Cement Investors* case. This Court, we respectfully submit, should clear up this matter of the application of Section 112(b) (5) to creditors' corporate reorganizations for once and for all.

V.

The decision of the Court of Appeals to the extent that it holds that the "solely for stock" requirement is applicable to Section 112(b) (5) is contrary to prior decisions of the Supreme Court and raises questions of federal law which should be settled by this court.

If the expression of doubt by the Court of Appeals as to compliance with Section 112(b) (5) was in any way based on the respondent Collector's argument relative to the supposed "solely for stock" requirement of said section, the Court's view in this regard is contrary to the holding in the *Cement Investors* case. The Supreme Court has already held that the "solely for stock" requirement does not apply under Section 112(b) (5). The Court will bear in mind that both Sections 112(b) (4) and 112(b) (5) have always employed the language, "solely for stock or securities." The courts have consistently taken the position that this phraseology relates to the form of the property received by the transferor, and the payment of cash by the transferee to some of the bondholders, for instance, does not violate the "solely for stock or securities" requirement of Sections 112(b) (4) and 112(b) (5). It was not until Section 112(g), defining the term "reorganization," was amended so as to require that the transferee corporation make the exchange "solely for all or a part of its voting stock" that the payment of cash to some of the bondholders by the transferee corporation was considered as preventing compliance with the requirements of a tax-free reorganization.

The definition of reorganization contained in the Revenue Act of 1932, then Section 112(i), did not set forth the "solely for voting stock" requirement. This Court construed the 1932 Act in *Helvering v. Alabama Asphaltic Limestone Co., 315 U. S. 179 (1942)*. It will be noted that the then definition of "reorganization" included "the acquisition by one corporation of at least a majority of the voting stock and at least a majority of the total number of shares of all other classes of stock of another corporation, or substantially all the properties of another corporation."

In the *Limestone* case the dissenting bondholders were paid in cash, and in considering whether the transaction complied with Section 112(b)(4) and the related reorganization definition, the Supreme Court did not in any way consider that the payment in cash to dissenters violated the "solely for stock or securities" requirement of Section 112(b)(4). While there is no specific mention of Section 112(b)(4) in the Court's opinion, it is self-evident that such section was under consideration. The reorganization definition supplements and relates to Section 112(b)(3), (4) and (5). The opinion of the Board of Tax Appeals shows that both Section 112(b)(3) and (4) were under consideration. *Alabama Asphaltic Limestone Co. v. Commissioner, 41 B. T. A. 324 (1940)*.

In *Helvering v. Southwest Consolidated Corporation, 315 U. S. 194 (1942)*, dissenting bondholders were also paid in cash. The Supreme Court expressly points out that the

transaction would have been a tax free reorganization under the statute involved in the *Limestone* case, but that the 1934 Act changed the reorganization definition so as to provide that the exchange be "solely for voting stock."

In addition to the foregoing clear-cut interpretations by the Supreme Court, the language of the statute itself makes it clear that the payment of cash in addition to "stock and securities" under Section 112(b)(1) to (5), inclusive, does not result in the recognition of loss. Section 112(e) of the Revenue Act of 1936, which controls the case at bar, provides as follows:

> "If an exchange would be within the provisions of subsection (b) (1) to (5), inclusive, of this section if it were not for the fact that the property received in exchange consists not only of property permitted by such paragraph to be received without the recognition of gain or loss, but also of other property or money, then no loss from the exchange shall be recognized."

As already shown, even if the transaction in question was required to comply with the "solely for stock" requirement, such requirement was met because the cash payment to dissenters was not made by the transferee corporation, and it delivered nothing but its voting stock in the exchange. In all events, the contention of the Collector that the "solely for stock" requirement applies to Section 112(b)(5) in the same manner as to Section 112(b)(4) and 112(g) and the Court's apparent agreement should, at this time, be overruled and the law definitely settled.

VI.

The decision of the Court of Appeals to the effect that a transaction under Section 112(b)(5) and Section 113(a)(8) results in the transferee corporation having the bondholders' basis rather than that of the old corporation is contrary to prior decisions of the Supreme Court and raises important questions of federal law which should be settled.

The Court of Appeals, in considering Section 112(b)(5) and Section 113(a)(8), made a holding that neither of the parties had contended for. Petitioner asserted that the basis of the property in the hands of the new corporation was the same as it was in the hands of the old corporation. The Collector contended that the bondholders' basis governed and that such basis was the fair market value at the date of the receiver's sale. The Court of Appeals stated:

> "Therefore, even if it be conceded that there was a nontaxable exchange under Section 112(b)(5), which we do not here decide, the bondholders would be the 'transferors' and their basis, not the old corporation's, would apply. Whatever the basis of the bondholders might have been, there is nothing in the record and no argument to show that it was the same as the old corporation's cost." (219 F. 2d 149 at 156.)

The refusal of the Court of Appeals to recognize the same basis for the new corporation as that of the old is completely opposed to the law announced in the Supreme Court's opinion in the *Cement Investors* case. The *Cement Investors* case was not a basis case and dealt with the question of the taxability of the exchange of bonds of the

old company for income bonds and common stock of the new company. The Supreme Court, however, dealt with the question at hand from the standpoint of whether or not the transfer of the property of the old corporation to the new corporation was a tax-free exchange. The transfer was held to be tax-free under Section 112(b)(5). The Court then held that an essential incident of the tax-free aspect of a transaction under 112(b)(5) is that there is no change in basis. It is respectfully submitted that the following language of the Supreme Court cannot possibly mean anything else:

> "* * * If a transaction meets the requirements of Section 112(b)(5), the basis of the property in the hands of the acquiring corporation is the same as it would be in the hands of the transferor. Section 113(a)(8). * * * A similar result obtains in case of a transaction which qualifies as a 'reorganization.' See Section 113(a)(7)(B). And the theory underlying the two basis provisions is the same." (316 U. S. 527 at 534.)

Respondent Collector, however, while apparently conceding the application of Section 112(b)(5) to the transaction involved in the *Cement Investors* case, applied such section in a manner that could not possibly have been contemplated by the Supreme Court. The Collector's position before the Court of Appeals in the case at bar was simply that the receiver's sale vested the title in the bondholders, thereby giving them a fair market value basis, and that they then transferred the property to the new taxpayer corporation and that this transfer was covered by Section 112(b)(5),

so that the fair market value basis of the bondholders was carried forward. The Collector argues that this is the effect of the Supreme Court's holding in the *Cement Investors* case.

The interpretation which the respondent placed on Section 112(b)(5) as applied to creditors' reorganizations obviously raises important problems in the administration of the income tax laws. If the Collector is right in holding that under the *Cement Investors* case Section 112(b)(5) applies so as to carry forward the bondholders' basis, rather than the basis of the old corporation, and that basis is the fair market value at the foreclosure sale, it is submitted the respondent completely repudiates the *Cement Investors* case.

The very essence of a tax-free corporate reorganization or exchange is to treat the foreclosure merely as a step in the overall transaction, and not as giving rise to a taxable event and the creation of a new basis. If the respondent is right in this connection, the *Cement Investors* case would appear to be much ado about nothing because no one questions the fact that if in an ordinary foreclosure the holders of mortgage obligations bid the property in and thereafter incorporate, the gain or loss is determined by the fair market value at the time of foreclosure, and a new basis is established. When the property is transferred to the corporation in exchange for its stock, there is no further tax as the transaction is tax-free under Section 112(b)(5). This, however, is not a tax-free transaction in the broad sense in which the Court construes it in the *Cement In-*

vestors case. A purported transaction which did not meet the definition of reorganization under Section 112(g), for instance, would be tax-free under Section 112(b)(5) in the sense in which the Government now construes the *Cement Investors* case. Typical examples are: *Helvering v. New President Corp., 122 F. 2d 92 (8 Cir., 1941)*, and *U. S. v. Santa Inez Co., 145 F. 2d 667 (9 Cir., 1944)*. In fact, the Collector cited these cases as sustaining its position in the Court of Appeals.

As stated above, the Court of Appeals presumably agreed with neither the taxpayer nor the Collector. The Court of Appeals agreed with the Collector to the extent of holding that the bondholders' basis would be carried forward, but apparently did not interpret this basis as being the cost at the receiver's sale but the cost to the bondholders of their bonds. This, of course, results in a change of basis despite the absence of a taxable event. It is respectfully urged that any change in basis destroys the tax-free aspect of the transaction and violates the rule of the *Cement Investors* case. To illustrate this point, if the bondholders' basis exceeded the old corporation's basis, a carry forward of their basis without taxable event would result in the new corporation having a higher basis than the old for depreciation, excess profits tax credit purposes and the like. If, on the other hand, the bondholders' basis was less than that of the old corporation, the new corporation would have a lower basis than the old, unaccompanied by taxable event. The only possible instance where the transaction would be completely tax-free under this approach would be where by

fortuitous circumstances the basis of the bondholders happened to be identical with that of the old corporation.

The decision of the Court of Appeals, furthermore, would actually lead in certain cases to the anomaly of having two subsections of Section 112(b) applicable to a given situation but resulting in a different basis to the new corporation, depending on which subsection is being applied at the time. A transaction might very well qualify under Section 112(b)(4) and Section 112(g) and, at the same time, comply with Section 112(b)(5). Certainly the Supreme Court has made this eventuality clearly possible under the holding in the *Cement Investors* case. The facts in the *Limestone* case illustrate this anomaly. That case was a basis case. Clearly, under the principle there established and affirmed in the *Cement Investors* case both Section 112(b)(4) and Section 112(b)(5) would be applicable. There would be no reason for giving either section precedence over the other; and yet to follow the view of the Court of Appeals, as expressed in the case at bar, would result in two different bases in the *Limestone* situation. Presumably, the divergent views entertained by the Court of Appeals and the Collector on the basis question arise from certain language of the Court in the *Cement Investors* case which has been clearly misinterpreted and should be clarified at this time.

In holding that Section 112(b)(5) was applicable in the *Cement Investors* case, the Supreme Court did nothing more than decide that the bondholders might be considered as the transferors for determining compliance with the

requirements of such section that control of the corporation remain the same. After quoting Section 112(h), which defined the term "control" as used in Section 112(b)(5), the Court states:

> "If it may be said that property was transferred by the bondholders to the new corporation, then the other requirements of Section 112(b)(5) were satisfied. For the bondholders, as owners of all of the outstanding stock of the new corporation were in 'control' of it 'immediately after the exchange.' And it has not been disputed that the stock and income bonds acquired by each bondholder were substantially in proportion to his interest in the assets of the debtor companies prior to the exchange." *(Helvering v. Cement Investors, Inc.*, 316 U. S. 527, 531.)

Clearly, the Supreme Court was not even remotely intimating that the bondholders were transferors for the purpose of determining the basis of the new corporation. The Court had already determined in the *Limestone* case that the old corporation was the transferor for basis purposes. The specific argument had been made that the bondholders' committee and not the old corporation was the transferor. The Supreme Court rejected this contention in the following language:

> "* * * Some contention, however, is made that this transaction did not meet the statutory standard because the properties acquired by the new corporation belonged at that time to the committee and not to the old corporation. That is true. Yet the separate steps were integrated parts of a single scheme. Transitory phases of an arrangement frequently are disregarded under these sections of the revenue acts where they add nothing of substance to the completed affair."

(Helvering v. Alabama Asphaltic Limestone Co., 315 U. S. 179, 184-185.)

If the Court of Appeals and the Collector are right in the instant case in holding that the bondholders were the transferors then, on the same reasoning, the bondholders would have been the transferors in the *Limestone* case. It could be argued with equal reason that in the *Limestone* case the bondholders, having acquired their equity ownership by virtue of insolvency, were the transferors to the new corporation; but the Supreme Court's holding is necessarily opposed to such reasoning. Where insolvency ensues and the creditors displace the stockholders, they control the corporation, and a transfer of properties incident to a reorganization is just as much effected by the corporation as though the displaced stockholders had remained in control. To adopt any other viewpoint is to repudiate the underlying reasoning of the *Limestone* case as well as to disregard the established vehicle of the corporate entity. The stockholders of a corporation do not own the corporate properties. The bondholders of an insolvent corporation who have stepped into the shoes of the stockholders do not own the corporate properties.

The stockholders of a solvent corporation in a corporate reorganization are not the transferors of the property, but they do direct and control the transfer in the same sense as the bondholders of an insolvent corporation direct and control the transfer. It is just as illogical to contend that the stockholders are the transferors of the property as it is to contend that the bondholders are such transferors. In

order to properly appraise the problem at hand, it must be realized that the income tax consequences of a reorganization as applied to the individual tax of stockholders or bondholders are separate and distinct from the corporate tax situation. There is no question but that the bondholders' basis in their bonds carry over as the basis for their new stock, but it would be a unique situation if this basis also became the basis of the assets in the hands of the new corporation. If this latter were true, there would not be a real postponement but merely a half-way postponement because, although there was no taxable event, we would find the basis of the assets changed. To relate the basis of bondholders or stockholders in their securities to the basis of the corporate properties is to completely overlook the corporate entity. Obviously, in reorganization situations the basis of new stock or bonds is related to the basis of old stock or bonds, adjusted for any gain or loss, and the basis of assets in the hands of the new corporation is related to the basis of the assets in the hands of the old corporation, again adjusted for gain or loss. If there is no gain or loss, then the status quo must necessarily be retained with regard to basis problems. If, in the process of the reorganization a bondholder's exchange of his old bonds for new stock was tax-free, there could logically be no change in basis of the corporate properties else the tax-free aspects of the transaction are destroyed. This would seem to conform to the general theories underlying the reorganization and tax-free exchange sections in the Internal Revenue Code generally.

WHEREFORE, your petitioner respectfully prays that a writ of certiorari be issued to the United States Court of Appeals for the Fifth Circuit to the end that this cause may be reviewed and determined by this Court; that the decree of the Court of Appeals for the Fifth Circuit be reversed and the decree of the District Court be reinstated, and that petitioner be granted such other and further relief as may be proper.

Respectfully submitted this 14th day of May, 1955.

ROBERT ALLAN RITCHIE,
ROBERT F. RITCHIE,
(Counsel for Service),
1100 Republic Bank Building,
Dallas 1, Texas,

SYLVAN LANG,
LESLIE BYRD,
1500 Milam Building,
San Antonio 5, Texas,
Attorneys for Petitioner, San Antonio Transit Company.

APPENDIX A

Opinion of the United States Court of Appeals for the Fifth Circuit in Scofield v. San Antonio Transit Company, 219 F. 2d 149

Before HUTCHESON, Chief Judge, RIVES, Circuit Judge, and DAWKINS, District Judge.

DAWKINS, District Judge: The Collector has appealed from an adverse judgment of the District Court in the taxpayer's suit for recovery of alleged illegally collected income, declared value excess profits and excess profits taxes for the fiscal year ending May 31, 1943.

The pertinent facts (stipulated in detail to the trial court) are as follows: Smith Brothers Properties Company, a Texas corporation (hereinafter called the old corporation), owned certain realty in San Antonio upon which it constructed buildings for its own use and for lease to others. Among the buildings it owned was the Smith-Young Tower building (hereinafter called Tower building) which it built in 1928 at a cost of $2,070,709.09, financed by first mortgage bonds in the amount of $1,900,000. A first mortgage deed of trust was executed to secure the payment of the bonds and interest coupons, whereby the property was conveyed to trustees.

By the end of 1930, the old corporation owned seven or eight business properties in San Antonio, and owed considerable debts secured by various other indentures against its realty. For the purposes of this appeal the entire indebtedness may be categorized into two groups of debts: (1) the

bonded indebtedness on the Tower building, and (2) the bonded and otherwise secured debts relating to other properties, taxes and unsecured claims.

A protective committee was formed by the Tower building bondholders and was vested with legal title to the bonds through the use of certificates of deposit. In November, 1931, the trustees named in the Tower building deed of trust declared all the bonds secured thereby due and payable; and in January, 1932, these trustees filed suit against the old corporation, seeking recovery of the entire debt due on the bonds, foreclosure of the bond lien and the appointment of a receiver. A receiver was appointed; but this did not vest him with title to the Tower building, which was still in the old corporation. Answer was filed by the latter with a cross-claim alleging usury.

In the latter part of 1932, or early 1933, the old corporation defaulted on its other secured debts, and all of its other properties were taken over by one Gill, agent for Massachusetts Mutual Life Insurance Company (hereinafter called Massachusetts), the holder of second and third mortgage notes against some of the properties. Gill was not judicially appointed, and the procedure employed by this group of creditors appears to have been entirely extrajudicial at that time. At any rate, the properties were in the hands of the creditors and were operated by Gill separately from the Tower building, then being operated by the receiver appointed in the trustees' foreclosure suit.

There was some maneuvering in the foreclosure suit, with respect to the defense of usury, as well as the asserted

personal liability of some of the stockholders of the old corporation; and as a consequence matters remained in substantially the same condition from early 1933 until 1937.

On April 1, 1937, Century Investment Company (hereinafter called Century) acquired a majority of the common stock of the old corporation and also purchased all the defaulted secured obligations then held by Massachusetts. Century then filed a foreclosure suit against the old corporation on the properties securing those obligations, a completely separate judicial action from the one already pending by the trustees of Tower building deed of trust. Pursuant to a previously arranged plan, all of those properties, other than the Tower building, were purchased at the Century's foreclosure sale by Plaza Company, created by Century for that particular purpose. The old corporation had no equity in the properties so sold, and it executed a quitclaim deed to Plaza Company for all the properties thus purchased. This was accomplished on or by May 4, 1937.

Meanwhile, in October of 1936, the protective committee for all the holders of Tower building bonds, entered into an agreement with Dallas Rupe & Son, Inc. (hereinafter called Rupe), also holder of some of the Tower bonds, for the "reorganization" of the Tower building alone. Under this agreement Rupe deposited with the committee a sum sufficient to buy the non-participating bonds at the rate of $20.00 for each $100.00 of principal amount of said bonds. The plan provided Rupe should receive voting trust certificates for the number of shares in a new company to which

the non-participating bondholders would have been entitled; and, *in addition*, Rupe was to receive certificates covering three per cent of the shares to be issued to all participating bondholders, including his own, and those purchased. In the plan Rupe also agreed to negotiate a loan to the new corporation for $100,000, to be secured by a first mortgage on the Tower building when acquired by it. The plan further provided the participating bondholders should receive voting trust certificates representing one share of common stock in the new corporation for each $100 of principal amount of bonds surrendered.

Pursuant to this agreement, the protective committee intervened in the foreclosure against the Tower building, setting forth the plan. The committee also agreed to assign all deficiency claims for the balance of principal and interest on the old bonds after the foreclosure to the old corporation, and the latter, in turn, agreed to withdraw all defenses to foreclosure proceedings.

On May 27, 1937, the court approved the plan and ordered the sale of the Tower building by the receiver appointed in 1933, and it was bid in by a nominee of the committee (not otherwise identified in the record) at foreclosure sale August 3, 1937, for $335,160. This sale was confirmed on August 27, following; and on August 31 the receiver conveyed the property, including building, lot, personal property and accounts receivable up to July 31, 1937, to Smith-Young Tower Corporation, the taxpayer herein.[1]

[1]By subsequent amendment of its charter, taxpayer's name was changed to San Antonio Transit Company.

On the same date, the price bid by the committee's nominee was paid to the receiver by delivery of $1,667,000 face value of bonds for a credit of $300,060 and the balance of the bid, or $35,100, was paid by the committee with the cash received from Rupe under the plan previously mentioned. At the same time taxpayer issued 18,620 shares of its voting stock to voting trustees provided in the plan in consideration of all property conveyed to it. The trustees in turn issued stock to the bondholders at the rate previously stated of one share for each $100 in principal amount of bonds surrendered—16,970 shares to all participating bondholders, and 1,650 shares to Rupe for bonds purchased from non-participants. Later Rupe received 558 additional shares, amounting to three per cent of the entire issue to participating bondholders under the arrangement above mentioned with the Bondholders Committee. The deficiency claims against the old corporation were transferred to it, thereby being extinguished by confusion; and the old corporation at the same time executed a quitclaim deed to all property transferred to the taxpayer.

In determining depreciation and equity invested capital on its tax returns for the fiscal year ending May 31, 1943, the taxpayer used the same adjusted basis for the Tower building as had been used by the old corporation. The Commissioner used the fair market value on the date title was acquired by taxpayer (August 31, 1937); a much lower figure, and assessed deficiencies. Taxpayer paid and brought this suit to recover, contending that it acquired the property as a result of a nontaxable reorganization under Sections 112(b)(4) and 112(g)(1)(B) of the Revenue Act

of 1936,[2] which entitled it to use the same basis as the old corporation under Section 113(a)(7).[3] Alternatively, it argued below and here that the transactions by which it acquired the property constituted a nontaxable exchange under Section 112(b)(5) of the Act[4] which entitled it to use the same basis, as provided in Section 113(a)(8).[5]

---

[2]"Sec. 112. RECOGNITION OF GAIN OR LOSS."

* * * * *

"(b) Exchanges solely in Kind.—"

* * * * *

"(4) Same—Gain of corporation.—No gain or loss shall be recognized if a corporation a party to a reorganization exchanges property, in pursuance of the plan of reorganization, *solely for stock* or securities in another corporation a party to the reorganization." (Emphasis supplied.) 49 Stat. 1678, 1679.

"(g) Definition of Reorganization.—As used in this section and section 113—

"(1) The term 'reorganization' means * * * (B) the acquisition by one corporation in exchange *solely for all or a part of its voting stock:* of at least 80 per centum of the voting stock and at least 80 per centum of the total number of shares of all other classes of stock of another corporation; or *of substantially all the properties of another corporation,* * * *." (Emphasis supplied.) 49 Stat. 1681

[3]"SEC. 113, ADJUSTED BASIS FOR DETERMINING GAIN OR LOSS.

* * * * *

"(7) Transfers to corporation.—If the property was acquired—

* * * * *

"(B) in a taxable year beginning after December 31, 1935, by a corporation in connection with a reorganization, then the basis shall be the same as it would be in the hands of the transferor, * * *." 49 Stat. 1683.

[4]"(5) Transfer to corporation controlled by transferor.—No gain or loss shall be recognized if property is transferred to a corporation by *one or more persons solely* in exchange for *stock* or securities in such corporation, and *immediately after the* exchange such person or persons are in *control* of the corporation; but in the case of an exchange by two or more persons this paragraph shall apply only if the amount of the stock and securities received by each is substantially in proportion to his interest in the property prior to the exchange." (Emphasis supplied.) 49 Stat. 1679.

"Control" was defined in Section 112(h) to mean "the ownership of stock possessing at least 80 per centum of the total combined voting power of all classes of stock entitled to vote and at least 80 per centum of the total number of shares of all other classes of stock of the corporation." 49 Stat. 1681.

[5]"(8) Property acquired by issuance of stock or as paid-in surplus.—If the property was acquired after December 31, 1920, by a corporation—(a) by the issuance of its stock or securities in connection with a transaction described in section 112 (b) (5) (including, also, cases where part of the consideration for the transfer of such property to the corporation was property or money, in addition to such stock or securities), * * * then the basis shall be the same as it would be in the hands of the transferor, * * *." 49 Stat. 1683.

The trial court held that taxpayer acquired the property in a tax-free reorganization and rendered judgment accordingly. He did not pass upon the alternative contention.

In *Helvering v. Alabama Asphaltic Limestone Company, 315 U. S. 179*, it was held that the full priority rule of *Northern Pacific Ry. Co. v. Boyd, 228 U. S. 482*, places creditors in the same position as the old stockholders when an insolvency "reorganization" is being considered under this statute. At the outset, then, it is apparent that in order to meet the statutory requirements, taxpayer must have acquired "subsantially all the properties" of the old corporation "*solely* for all or a part of" taxpayer's voting stock.

However, taking into consideration the underlying congressional purpose of postponing tax consequences when there has been a change in form only, the courts have implemented the statutory language by establishing the "continuity of interest" test.[6] There have been many cases involving this problem, some of which also discussed "continuity of interest," each being decided on its own facts; but any attempt to summarize or discuss them all would unduly lengthen this opinion. As we understand the rationale of the cases, the courts do not purport to express any precise, iron-clad rule against which "continuity of interest" can be measured in every case. Compositely, the cases

[6]See, for example, *Pinellas Ice & Cold Storage Company v. Commissioner*, 287 U. S. 462 (1933); *LeTulle v. Scofield*, 308 U. S. 415 (1940); *Nelson Company v. Helvering*, 296 U. S. 374 (1935); *Helvering v. Minnesota Tea Company*, 296 U. S. 378 (1935, affirming 76 F. 2d 797) and *Southwest Natural Gas Company v. Commissioner*, 189 F. 2d 332, 334 (C. A.—5, 1951). See also, *Palm Springs Holding Corporation v. Commissioner*, 315 U. S. 185; *Bondholders Committee, Marlborough Investment Co. v. Commissioner*, 315 U. S. 189; *Helvering v. Southwest Consolidated Corp.*, 315 U. S. 194.

mean simply that facts must be presented from which it can reasonably be concluded that the new corporation is in substance the old corporate enterprise in a new form.[7] Thus, it is seen that a creditor's plan must not only satisfy the literal language of the statute, but must also meet the "continuity of interest" test.

Appellant earnestly contends that the arrangement by which the interests of the dissenting bondholders were acquired by Rupe was actually a disguised transaction under which the corporation acquired part of the creditors' interest for cash. This being true, it argues, the taxpayer did not acquire the property *solely* for voting stock as required by the statute, citing *Helvering v. Southwest Consolidated Corp.*, supra, footnote 6. This contention raises a serious and very close question; but since we have concluded that the "reorganization" involved here does not satisfy the continuity of interest test, we deem it unnecessary to pass upon the effect of the Rupe agreement as to the cash payment.

As was said in the *Limestone* case, supra, "When the equity owners are excluded and the old creditors become the stockholders of the new corporation, it conforms to realities to date their equity ownership from the time when they invoked the processes of the law to enforce their rights

[7] See Treasury Regulation 94, promulgated under the Revenue Act of 1936 (Code of Federal Regulations, 1st Edition, Title 26, Section 3.112 (a)-1, pages 246-247), which stated: "* * * The underlying assumption of these exceptions is that the new property is substantially a continuation of the old investment still unliquidated; and, *in the case of reorganizations, that the new enterprise, the new corporate structure, and the new property are substantially continuations of the old still unliquidated.*" (Emphasis supplied.)

of full priority. *At that time they stepped into the shoes of the old stockholders.*" (Emphasis supplied.) So it is clear that the rights of creditors under this statute are *derivative* rights—that they cannot have greater rights than the stockholders of the insolvent corporation would have had. Further, it is clear that their rights to claim a nontaxable reorganization under the statute date from the time when, because of insolvency, they displaced the stockholders. It follows that in the instant case, we must begin our consideration with the circumstances as they existed in late 1932 or early 1933, when the old corporation was in default on all its secured indebtedness and the creditors "stepped into the shoes of the old stockholders."

At that time the old corporation, though insolvent, was a unit—one business enterprise. When they displaced the stockholders the creditors voluntarily aligned themselves into two separate groups; and each group then took separate action affecting not the old corporation as an enterprise, but only the properties thereof. Each group operated only the properties connected with its respective claims, and it did so independently of the other group in separate proceedings. Obviously, the purpose of each group of creditors was to salvage the *property* against which it had claims, not to reorganize the old corporation as a going concern. There is nothing in the record to indicate that either group made any effort to become parties to or otherwise participate in the proceedings being conducted by the other group. When they separated and went their respective ways with only that portion of the properties to which

their claims related, the creditors in effect dissected or carved the old corporation into two separate entities. When the Tower building was transferred to the taxpayer only the shell of the old corporation was left; the business enterprise which it had represented no longer existed; it had been decimated by the action of the other group of creditors; it could not be recast into a new and modified form in the sense contemplated by the statute requiring the transferee to acquire "substantially all the properties" of the old corporation.

In its brief taxpayer argues that in a situation such as the one presented here, either group of creditors may "reorganize" under the statute, with the other creditors disregarded for the purpose of the statutory test because of their lack of equity in the property transferred, citing *Peabody Hotel Company v. Commissioner, 7 T. C. 600.* It is true that in the *Peabody* case the Tax Court found a "reorganization" from insolvency proceedings which separated one group of properties from the mass and conveyed it to bondholders. It is also true that there may be language in the Tax Court's opinion which lends comfort to taxpayer's position. But it should be noted that in the *Peabody* case there was one unified insolvency proceeding under Section 77 of the Bankruptcy Act; that each phase of the series of events was under court direction *in the one proceeding* to which *all* creditors were parties; that the new corporation was found to be the substance of the insolvent corporation after the reorganization; and that the entire plan was approved by the requisite proportion of *all* credi-

tors. The business enterprise of the old corporation was held intact throughout the proceeding, notwithstanding the transfer of one group of properties to another corporation. The division of the property took place as part of the one overall plan of reorganization. The *Peabody* case, therefore, is clearly distinguishable on its facts.

We do not base our conclusion here on any calculation of the percentage of the old corporation's property transferred to the taxpayer. Nor do we hold that it is necessary for all or any particular number of the old creditors to become stockholders in the new corporation. We simply hold that in this case, where the taxpayer acquired what amounts to only one property of a substantial enterprise as a result of proceedings and activities completely separate from all other property and from the claims of all other creditors, the necessary continuity of interest is not shown. Under no reasonable view can it be said that the old corporation has emerged as substantially the same enterprise in new form or that substantially all of its property was transferred to the new corporation.

If taxpayer's contention were adopted, it would be possible for the creditors of an insolvent corporation to effect as many nontaxable "reorganizations" as there were secured claims against assets. Each such creditor could foreclose against the particular asset securing his claim, transfer the asset to a new corporation and successfully contend that the new corporation was the new form of the old corporation. We are confident no such result was intended by Congress.

As stated earlier, taxpayer made an alternative argument below (incorporated in its complaint) to the effect that it acquired the Tower building and properties in a nontaxable exchange under Section 112(b)(5) and was therefore entitled to use the old corporation's basis under Section 113(a)(8). If we agreed with this contention we should affirm the judgment appealed from, even though the trial judge did not pass upon the question.[8] However, we are unable to sustain the judgment on this ground.

In the first place, there is considerable doubt that Section 112(b)(5) applies to an attempted creditors' reorganization effected in the manner presented to us here. But even if we assume, without deciding, that the series of events satisfied the language and purpose of 112(b)(5), we could not affirm the judgment, for the plain language of 113(a)(8) requires the transferee corporation to use the basis of its *transferor*.

Here, the bondholders completely displaced the stockholders in the old corporation and the latter, as we have said, was obliterated for all practical purposes. The bondholders operated the Tower building through the receiver appointed in their foreclosure suit for some five years prior to the transfer to taxpayer. We find it impossible under these circumstances to consider the old corporation as having transferred the Tower building to taxpayer in exchange

[8] *R. E. Crummer & Co. v. Nuveen*, 147 F. 2d 3 (7 Cir.). See also *J. E. Riley Investment Co. v. Commissioner*, 311 U. S. 55; *Ohio Casualty Ins. Co. v. Marr*, 98 F. 2d 973 (10 Cir.); *Standard Oil Co. v. Lyons*, 130 F. 2d 965 (8 Cir.); *Petersen v. Coast Cigarette Vendors, Inc.*, 131 F. 2d 389 (9 Cir.); *In re Barlum Realty Co.*, 154 F. 2d 562 (6 Cir.); *Kam Koon Wan v. E. E. Black, Ltd.*, 188 F. 2d 558 (9 Cir.).

for the latter's stock. See *Helvering v. Southwest Consolidated Corp., 315 U. S. 194, 202; Helvering v. Cement Investors, Inc., 316 U. S. 527.*

Therefore, even if it be conceded that there was a nontaxable exchange under Section 112(b)(5), which we do not here decide, the bondholders would be the "transferors" and their basis, not the old corporation's, would apply. Whatever the basis of the bondholders might have been, there is nothing in the record and no argument to show that it was the same as the old corporation's cost.

Taxpayer's complaint sought recovery of taxes based upon other alleged illegal findings by the Commissioner; and it is impossible to tell from the record whether any of its other claims were incorporated in the judgment rendered in its favor. Accordingly, the judgment appealed from its reversed, and the matter is remanded for whatever further proceedings or computations are necessary, consistent with the views expressed herein.

REVERSED AND REMANDED.

ON PETITION FOR REHEARING

PER CURIAM: The petition for rehearing in the above styled and numbered cause is hereby

DENIED.

RIVES, Circuit Judge: I dissent.

RIVES, Circuit Judge, Dissenting.

Further consideration has convinced me that the taxpayer corporation acquired the assets of Smith Brothers

Properties Company in a nontaxable reorganization as defined in Section 112 (g) (1) (B) of the Revenue Act of 1936 (quoted in footnote 2 to the main opinion). The appellant collector insisted that there was no such reorganization upon the following grounds: (A) A continuity of interest, which is requisite to a reorganization, was lacking; (B) The taxpayer did not acquire "substantially all the properties" of the alleged transferor; (C) The taxpayer did not acquire the property of the transferor "solely" for "voting stock."

(A) CONTINUITY OF INTEREST

This ground of attack, or this ground coupled with (B), "substantially all the properties," was the ground sustained in our original opinion:

> "We simply hold that in this case, where the taxpayer acquired what amounts to only one property of a substantial enterprise as a result of proceedings and activities completely separate from all other property and from the claims of all other creditors, the necessary continuity of interest is not shown. Under no reasonable view can it be said that the old corporation has emerged as substantially the same enterprise in new form or that substantially all of its property was transferred to the new corporation."

The broad rationale of tax-free corporate reorganizations is thus stated in 3 Mertens Law of Federal Income Taxation, Section 20.50, p. 183:

> "The justification for the exemption from taxation of gains realized in corporate reorganizations is that the parties making the exchanges have simply changed

> the form of their corporate holdings and that what was formerly a corporate business carried on by a particular corporation, or corporations, in a particular corporate form, or forms, is to be now carried on and continued by other and perhaps new corporations having new corporate form."

Applying that rationale, the courts have developed certain basic requirements implicit, if not expressed, in the statutes. 3 Id. Sec. 20.49, et seq. Among these is the "continuity of interest" test developed in *Pinellas Ice and Cold Storage Company v. Commissioner, 287 U. S. 462,* and *Le Tulle v. Scofield, 308 U. S. 415.* The essence of the "continuity of interest" rule is that the transferor or its stockholders must receive stock or a proprietary or equity interest in the transferee as opposed to solely a creditor's interest. Since the *Pinellas* and *Le Tulle* decisions, this requirement has been embodied in what is now Section 112(g)(1)(C), requiring that the exchange be "solely for all or a part of its (the new corporation's) voting stock." It seems to me that, though the continuity of interest requirement in such reorganization was theretofore implicit, it then became expressed and that if the requirement of the statute is met that is all that is necessary.

A very clear discussion of the "continuity of interest" requirement is contained in an article in the March, 1954, Tax Law Review published by the New York University School of Law on "Realignment of Stockholders' Interests in Reorganizations Under Section 112(g)(1)(D)." While that article relates to reorganization under Section 112(g)

(1) (D)[1] rather than under Section 112 (g) (1) (B), as in our case, the hypothetical case with which it concerns itself is very much the same as the case before us, and is stated as follows at the beginning of the article:

> "A and B are the sole stockholders (each owning a substantial block of the stock) of a corporation engaged in conducting two separate operations, each of which in itself is a substantial business. They are actively engaged in managing the affairs of the corporation and have devoted a good part of their lives to it. They have reached an impasse on a fundamental question of management policy affecting the future course of the business of the corporation. Neither wishes to sell his interest and neither wishes to liquidate. What they would like to do is to divide the business into two corporations, each corporation taking over one of the operations, A acquiring control of one corporation and B acquiring control of the other, so that each may pursue what he regards as the proper management policy in conducting one of the two divisions of the existing business.
>
> "To what extent is it possible to effect a reorganization of the business to accomplish this result and also to vest the ownership of the stock of one corporation in A and the other in B, without recognition of gain to the existing corporation and its stockholders? This question in its various aspects is the subject of this paper."

That article insists that there can be and is "a strict statutory test of continuity of interest," page 239, see also page 240. It quotes as the post-1934 concept of continuity of in-

[1]Sub-section (D), as it now reads, was not in force at the time of the reorganization in the present case. It was amended to read in its present form by Section 213(b) of the Act of June 29, 1939, and made applicable to tax years beginning after December 31, 1938, by Section 213(e) of said Act. See Historical Note to 26 U. S. C. A. 112; 26 U. S. C. A. Internal Revenue Acts, 1924 to Date, pp. 1176, 1177; 53 Stat. 862-885.

terest what this Court had stated in *Southwest Natural Gas Company v. Commissioner, 5th Cir., 189 F. 2d 332, 334:*

> "While no precise formula has been expressed for determining whether there has been retention of the requisite interest, it seems clear that the requirement of continuity of interest consistent with the statuory intent is not fulfilled in the absence of a showing: (1) that the transferor corporation or its shareholders retained a substantial proprietary stake in the enterprise represented by a material interest in the affairs of the transferee corporation, and, (2) that such retained interest represents a substantial part of the value of the property transferred."

In the present case, the retained interest was common stock, the purest form of proprietary or equity interest in a corporation, and that stock represented the full value of the property transferred. It seems clear to me that the court made rule of continuity of interest has been met. Whether the stricter statutory test was also complied with is the subject of ground of attack (C) to be briefly discussed hereinafter.

(B) "SUBSTANTIALLY ALL THE PROPERTIES"

In our original opinion, referring to the Limestone Case, *315 U. S. 179*, we held that the critical time for determining whether the taxpayer acquired "substantially all the properties" of the transferor was 1932 or 1933, the date of insolvency, rather than 1937, when the title to the property passed to the new corporation. It now seems clear to me that, under the teachings of the Limestone Case, *supra*, the

earlier date has reference only to the time when the bondholders stepped into the shoes of the stockholders, and that the later date is the one when the reorganization was perfected, and which we should consider in determining whether the taxpayer acquired "substantially all the properties" of the old corporation. In the Limestone Case, *supra*, the tax-free reorganization was approved even though the bondholders had theretofore stepped into the shoes of the stockholders. In the present case, as of 1937, there can be no question but that the taxpayer acquired not substantially, but literally, all of the properties of Smith Brothers Properties Company.

In 1932 or 1933, the separate sets of bondholders stepped into the shoes of the stockholders. The bondholders were divided into two separate groups, each interested in the properties securing their respective bonds. Neither group was interested in the other group or in the properties securing its bonds, because the corporation was insolvent, the security represented the value of the bonds of either group and was insufficient to pay those bonds in full. There was no remaining equity in which the other group could be interested. In 1932 or 1933, the properties of Smith Brothers Properties Company were thus, in effect, split into two portions, and as to each portion separately the bondholders stepped into the shoes of the stockholders. Further, the other group of bondholders and the security for its bonds had been completely severed from the old corporation before the present reorganization was effected. While, therefore, it may not be necessary for a decision of the case,

there seems to me to be no objection to divisive or multiple reorganization. That was held by the Tax Court in *Peabody Hotel Company v. Commissioner, 7 T. C. 600,* and is further demonstrated in the Tax Law Review article heretofore referred to, and in a number of decisions cited by appellee in support of its petition for rehearing.[2]

(C) "SOLELY FOR VOTING STOCK"

The taxpayer corporation itself parted with nothing but voting stock in acquiring the Tower Building. The fact that part of that voting stock went to reimburse or compensate Rupe & Son, who furnished the funds to pay off the nonassenting bondholders, representing about 10% of the total bonds, does not defeat this requirement. The taxpayer got the property "solely for voting stock," even though Rupe & Sons stepped into the shoes of the dissenting bondholders.

Originally, at the time of its formation as Smith & Young Tower Corporation, taxpayer's only asset, received in exchange for all of its then outstanding voting stock, was the Smith-Young Tower Building. The net result of the reorganization was that the bondholders who had in 1932 or 1933 become the equity owners of the Smith-Young Tower Building became the stockholders of the taxpayer corporation which had as its only asset the same building. The bondholders simply changed the form of their cor-

[2]In re Prudence Bonds Corporation, 2nd Cir., 79 F. 2d 205; In re Parker-Young Co. (D. Ct. N. H.), 15 F. Supp. 965; Morley Cypress Trust v. Commissioner, 3 T. C. 84; Cullinan v. Walker, 262 U. S. 134; Rockefeller v. United States, 257 U. S. 176; Reilly Oil Company v. Commissioner, 5th Cir., 189 F. 2d 382; Lewis v. Commissioner, 1st Cir., 176 F. 2d 646.

porate holdings. It appears to me that all of the requirements of a nontaxable reorganization as defined in Section 112(g)(1)(B) of the Revenue Act of 1936 have been met.

So thinking, I would express no opinion on the taxpayer's alternative position that it acquired the Tower building in a nontaxable exchange under Section 112(b)(5) further than to say that I think that we erred in holding that the bondholders rather than the old corporation transferred the Tower building to taxpayer. *Cf. Bard-Parker Co., Inc. v. Commissioner, 2nd Cir., ... F. 2d ...., December 6, 1954.*

I respectfully dissent.

APPENDIX B

STATUTES INVOLVED

Revenue Act of 1936, c. 690, 49 Stat. 1648, as amended by Revenue Act of 1938, c. 289, 52 Stat. 574, and Revenue Act of 1939, c. 247, 53 Stat. 862, U. S. C., Title 26:

SEC. 112. RECOGNITION OF GAIN OR LOSS.

(a) General Rule.—Upon the sale or exchange of property the entire amount of the gain or loss, determined under section 111, shall be recognized, except as hereinafter provided in this section.

(b) Exchanges Solely in Kind.—

* * * * *

(4) Same—Gain of corporation.—No gain or loss shall be recognized if a corporation a party to a reorganization exchanges property, in pursuance of the plan of reorganization, solely for stock or securities in another corporation a party to the reorganization.

(5) Transfer to corporation controlled by transferor.—No gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock or securities in such corporation, and immediately after the exchange such person or persons are in control of the corporation; but in the case of an exchange by two or more persons this paragraph shall apply only if the amount of the stock and securities received by each is substantially in proportion to his interest in the property prior to the exchange. Where the transferee as-

sumes a liability of a transferor, or where the property of a transferor is transferred subject to a liability, then for the purpose only of determining whether the amount of stock or securities received by each of the transferors is in the proportion required by this paragraph, the amount of such liability (if under section 213 of the Revenue Act of 1939 it is not considered as "other property or money") shall be considered as stock or securities received by such transferor * * *.

* * * * *

(e) Loss from exchanges not solely in kind. If an exchange would be within the provisions of subsection (b) (1) to (5), inclusive, of this section if it were not for the fact that the property received in exchange consists not only of property permitted by such paragraph to be received without the recognition of gain or loss, but also of other property or money, then no loss from the exchange shall be recognized.

* * * * *

(g) Definition of Reorganization.—As used in this section and section 113—

(1) The term "reorganization" means (A) a statutory merger or consolidation, or (B) the acquisition by one corporation, in exchange solely for all or a part of its voting stock, of substantially all the properties of another corporation, but in determining whether the exchange is solely for voting stock the assumption by the acquiring corporation of a liability of the other, or the fact that property acquired

is subject to a liability, shall be disregarded; or the acquisition by one corporation in exchange solely for all or a part of its voting stock of at least 80 per centum of the voting stock and at least 80 per centum of the total number of shares of all other classes of stock of another corporation, or (C) a transfer by a corporation of all or a part of its assets to another corporation if immediately after the transfer the transferor or its shareholders or both are in control of the corporation to which the assets are transferred, or (D) a recapitalization, or (E) a mere change in identity, form, or place of organization, however effected.

* * * * *

SEC. 113. ADJUSTED BASIS FOR DETERMINING GAIN OR LOSS.

(a) Basis (Unadjusted) of Property.—The basis of property shall be the cost of such property; except that—

* * * * *

(7) Transfers to corporation.—If the property was acquired—

(A) after December 31, 1917, and in a taxable year beginning before January 1, 1936, by a corporation in connection with a reorganization, and immediately after the transfer an interest or control in such property of 50 per centum or more remained in the same persons or any of them, or

(B) in a taxable year beginning after December 31, 1935, by a corporation in connection with a reorganization,

then the basis shall be the same as it would be in the hands of the transferor, increased in the amount of gain or decreased in the amount of loss recognized to the transferor upon such transfer under the law applicable to the year in which the transfer was made. This paragraph shall not apply if the property acquired consists of stock or securities in a corporation a party to the reorganization, unless acquired by the issuance of stock or securities of the transferee as the consideration in whole or in part for the transfer.

(8) Property acquired by issuance of stock or as paid-in surplus.—If the property was acquired after December 31, 1920, by a corporation—

(A) by the issuance of its stock or securities in connection with a transaction described in section 112(b)(5) (including, also, cases where part of the consideration for the transfer of such property to the corporation was property or money, in addition to such stock or securities), or

(B) as paid-in surplus or as a contribution to capital,

then the basis shall be the same as it would be in the hands of the transferor, increased in the amount of gain or decreased in the amount of loss recognized to the transferor upon such transfer under the law applicable to the year in which the transfer was made.

* * * * *

TREASURY REGULATIONS 94, promulgated under the Revenue Act of 1936:

Art. 112(a)-1. Sales or exchanges.—The extent to which the amount of gain or loss, determined under section 111, from the sale or exchange of property is to be recognized is governed by the provisions of section 112. The general rule is that the entire amount of such gain or loss is to be recognized.

An exception to the general rule is made by section 112 (b) (1) to (5), inclusive, in the case of certain specifically described exchanges of property in which at the time of the exchange particular differences exist between the property parted with and the property acquired, but such differences are more formal than substantial. As to these, the Act provides that such differences shall not be deemed controlling, and that gain or loss shall not be recognized at the time of the exchange. The underlying assumption of these exceptions is that the new property is substantially a continuation of the old investment still unliquidated; and, in the case of reorganizations, that the new enterprise, the new corporate structure, and the new property are substantially continuations of the old still unliquidated.